Transitional Excess Acquisition Costs

Prior to the enactment of the Cable Act of 1992, operators made business decisions about acquisitions and combinations based on the underlying economics of the transactions. Many of these transactions occurred upon passage of the Cable Communications Policy Act of 1984. At that time, the prices charged for the retransmission of broadcast signals in most cable systems were deregulated. These economics assumed that there were no regulatory constraints which limited recovery of excess acquisition costs through prices. Failure to give weight to the investments made in full compliance with the then existing regulatory policy would unfairly jeopardize the financial health of many cable operators.

Arthur Andersen proposes a pragmatic solution as an alternative to considered by the Commission to resolve this tough situation. Our proposal is a transitional approach to establish a current value for the property, plant and equipment of cable operators as of the date the Cable Act was enacted. Under the transition approach, cable operators would establish the trended original cost or fair market value of the system as of the enactment of the Cable Act of 1992. The trended original cost will act as a ceiling, and to the extent the cable operator can establish that this amount was "paid for", either through original cost payments, purchases, including any excess acquisition costs, or through payments to build or acquire its customer base, such trended original cost would be deemed recoverable.

Trended original cost could be determined by indexing the original cost of property, plant and equipment for changes in prices occurring subsequent to the year of expenditure. The trended original cost would then be depreciated through the date the Cable Act of 1992 was enacted using depreciation lives prescribed by the Commission.

Next, the cable operator would determine the costs incurred to develop its existing customer base. Substantial investment has been made to build this customer base. As more customers are added to the system, the entire customer base typically benefit through reduced costs per customer.

The costs associated with the customer base investment include costs incurred to acquire the franchise, marketing and other advertising costs and any other costs directly associated with obtaining and retaining customers on the system. Most of these costs were previously expensed for financial reporting purposes in the period incurred. However, because many cable operators have reported accumulated deficits, it is apparent that such costs have not been previously recovered. To determine the transitional recoverability of excess acquisition costs, the cable operator would quantify customer base development costs and trend such costs forward to the enactment of the Cable Act of 1992. An appropriate amortization period could be prescribed for these costs by the Commissions. The amortization period should be linked to the average time the residence is connected to the cable distribution system.

The current value of the property, plant and equipment and customer base investment serve as a ceiling for the transitional rate base. To the extent the cable operator is able to demonstrate it has "paid for" such assets and investment, the transitional rate base would be supported. In addition to return on transitional rate base, recovery of annual depreciation and amortization would be included in the determination of cost of service rates. However, as previously discussed, rates would be capped at the levels existing upon enactment of the Cable Act of 1992.

Our proposed alternative approach is perhaps best illustrated through the following simplified example.

<u>Assumptions</u>

1. A cable operator acquired a system in 1985 for $1,500,000.
2. At the time of acquisition, the seller's net book value was:

Original cost	$1,200,000	(Originally acquired in 1983)
Accum. Dep.	(200,000)	(Est. book life of 12 years)
Net Book Value	$ 1,000,000	

3. Customer base development costs were $150,000.
4. Using indices, the trended original cost of the property, plant and equipment at the enactment of the Cable Act is $1,400,000. The Commission establishes 20 years as the life of this type of property, plant and equipment.
5. Using indices, the customer base development costs in current dollars as of effective date of the Cable Act is $200,000. An average installation remains on the customer premises for 25 years.
6. Regulated services represent 90% of total channels on the system.
7. The cable operator decides to use cost of service to justify its existing rates. A 1992 test period is used.

Using the above assumptions, the transition rate base element of the overall rate base determination is computed in the following manner.

Transitional Rate Base Computation:

Property, plant and equipment component:	
Trended original cost at transition	$ 1,400,000
Trended accumulated depreciation (using a 20 year life, $70,000 per year times 9 years in service)	(630,000)
Property, plant and equipment ceiling (A)	$ 770,000
Customer development cost component:	
Trended customer development costs	$ 200,000
Amortization for 9 years, using 25 year life	(72,000)
Customer development cost ceiling (B)	$ 128,000
Subtotal (A+B)	$ 898,000
Allocation factor	90%
Maximum rate base	$ 808,000
Test of rate base:	
Amount paid for property, plant and equipment	$ 1,500,000
Accumulated depreciation using 20 yr. life	(675,000)
Property, plant and equipment "paid for" (A)	$ 825,000
Amount paid for customer base development	$ 150,000
Accumulated Amortization using 25 yr. life	$ (54,000)
Customer development costs "paid for" (B)	$ 96,000
Subtotal (A+B)	$ 921,000
Allocation factor	90%
Computed rate base	$ 829,000

In this example, the cable operator would be permitted to include $808,000 in rate base (the amount of the trended, current value "paid for"). Annual amortization allowable as an operating expense would consist of $70,200, (annual depreciation of $70,000 plus annual amortization of $ 8,000 times the 90% allocation factor). Return on and recovery of such amounts would be included in a cost of service filing to cost-justify rates existing upon enactment of the Cable Act of 1992.

It should be emphasized that in this example, if no business combination occurred and the "seller" continued as the cable operator, there would be no write up for trended original cost of property, plant and equipment because such owner did not "pay" in excess of the original investment. However, it may be appropriate to establish a property, plant and equipment base for such operator taking into consideration lives prescribed by the Commission to the extent they differ from lives previously used by the cable operator.

Some additional considerations related to our proposed approach are described below.

- It would be unnecessary to distinguish between the various sources of excess acquisition cost for purposes of implementing our proposed transitional approach. In many cases, appraisals and other valuations necessary for this breakdown of purchase price may not be available. The focus of this approach is the current value as of the date the regulations become effective. As long as the cable operator can support that current value has been "paid for", such amount should be considered in the ratemaking process.

- The amortization period for the customer base development investment costs is an important element of our proposed transitional approach. The Commission should prescribe lives that take into account that services installed on customer premises have lengthly lives and are not likely to follow specific customers.

- Even under our transitional approach, it would be necessary for the operator to demonstrate that costs in excess of original costs are reasonable and prudent to prove in the costs incurred. This would be necessary in connection with the first cost of service rate filing only. It could be accomplished by presenting evidence that the cost per subscriber paid for the system was reasonable in relation to prices paid by other operators during the same time period for systems with similar attributes. Public information about transactions is available and could be used for this purpose. The Commission could set benchmark prices using these same information sources to limit the burden on LFA's. Once this showing has been made and accepted, it should not be required to be repeated in future filings.

- For acquisitions and combinations which occur after the date that these regulations become effective, the cable operator would be required to demonstrate that customers will benefit from the transaction in order to include amounts in excess of original cost in the determination of cost of service rates. Because all parties will be aware of the requirements, this information can be factored into future purchases.

Rate Base For Subsequent Additions

Additions to property, plant and equipment made subsequent to enactment of the Cable Act of 1992 will be treated in accordance with traditional, original cost and prudent investment standards.

Rate of Return

The Commission tentatively concluded that a unitary rate of return should be established for all cable operators and seeks comments on this conclusion and how to establish the rate.[21]

There is little question that a unitary rate of return is the only feasible option. As to the methodology, we agree with the Commission that the approach it has used for setting the rate of return for telecommunications carriers i.e., discounted cash flow, is not useful because it relies heavily on dividend yields which are generally not common in the cable industry. A comparable risk or risk premium approach is better suited for this purpose.

Whatever approach is taken by the Commission, it will be useful to establish the assumed capital structure and relative rates of return for the debt and equity components. The equity return is needed to determine income tax expense. If the Commission's approach does not facilitate this necessary breakdown of capital sources and costs, it would be reasonable to specify a standard structure for this purpose.

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21 Notice at ¶ 46.

Test Year

Conceptually, the most appropriate test period is a 12 month period representative of the period for which the rates will be in effect. Because rates are set prospectively, either forecasted or adjusted historical information can be used. The latter is the most widely-accepted approach and appears to be the most practical for cable operators.

It is beneficial to utilize the most recently completed annual accounting period available at the time of the rate filing. In most cases, this period will be a calendar year, although some cable operators utilize a fiscal year. A significant advantage of using the normal accounting period is that it reflects appropriate period-ending adjustments and has usually been subject to an independent audit.

The historical test period should be adjusted for "known and measurable" changes. The Commission should specify the time frame for such adjustments to avoid confusion as to whether an adjustment qualifies under this standard. For example, the Commission could specify that the historical test year should be adjusted for changes through the date of the rate filing, the date the rates are expected to go into effect or some point during the period the rates will be in effect.

Cost Accounting and Cost Allocation Requirements

Uniform System of Accounts

The Commission observed that prescribed accounts have not been maintained by cable operators and solicits comments on the relative costs and benefits of a USOA.[22]

Arthur Andersen believes that a simplified USOA will be essential to ensure the consistency of accounting, ratemaking and reporting of cable operators which elect the option for cost of service regulation. Companies that elect benchmarking should only be subject to the Commission's existing requirement to follow GAAP.

From our experience with the extensive debate on the rewrite of the Commission's USOA for telecommunications carriers[23], several principles should be followed in developing a USOA:

- Accounting principles in the USOA should, in all cases, be based on GAAP.
- The account structure should facilitate costing, but the accounts themselves should not contain excessive detail.
- Guidelines should be provided in areas where GAAP is not specific, such as capitalization versus expense and depreciation.

The most effective way to develop a USOA for cable operators would be for the Commission to establish general principles as part of this proceeding. The guidelines included in Appendix A to the Notice appear reasonable and could serve this purpose. The cable operators collectively should be directed to submit a proposed USOA to the Commission which reflect these principles. The Commission could then follow applicable due process procedures before ultimately adopting a USOA which conforms with FCC standards and has the support of cable operators.

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[22] Notice at ¶ 58.
[23] CC Docket 78-196.

Cost Allocation Requirements

In the benchmark rulemaking, the Commission previously established cost allocation principles requiring expenses and revenues to be aggregated at either the franchise, system, regional or company level in a manner consistent with existing practices as of April 3, 1993. Costs aggregated at a higher level are to be allocated among franchises based on the relative numbers of subscribers in the franchise. Costs are to be allocated between tiers based on the relative number of channels in the tier. Costs of programming and retransmission consent fees are to be allocated to the specific tier where the programming is offered, franchise fees are to be allocated to equipment and installation, programming and other categories consistent with how they are assessed, and costs of public, educational and government access are to be allocated to the basic tier. Comment is sought on whether a different or supplemental methodology should be proposed for cost based rate determinations and whether supplemental requirements should be adopted for allocating between regulated and unregulated activities given the trend toward multimedia services. The Commission also seeks comments on the relative merits of rate averaging.[24]

We believe that the Commission's principles governing regulated/nonregulated cost allocations by telecommunications carriers would be equally applicable to cable operators.[25] In fact, given that cable operators and telecommunications companies will likely directly compete for multimedia services, parity is essential. The Commission's principles require that costs should be first directly assigned to the maximum extent possible, causally attributed when they cannot be directly assigned, and finally, generally allocated based on the ratio of expenses directly assigned and attributed.

[24] Notice at ¶ 59.
[25] 47 C.F.R. Section 64-901.

The allocation of costs between tiers based on the relative number of channels as proposed by the Commission is potentially short-sighted. Looking ahead to a multimedia environment where voice, data, and video services are provided over the same facilities, a common denominator that will allow for allocations of shared facilites such as fiber optic distribution facilities must be developed. Unfortunately, because the costs are shared, there is no economically accepted means to allocate such costs. Cost of service regulation forces such allocations to be made and is one of its often cited shortcomings. Given this form of regulation, however, possible measures could include bandwidth utilization, usage, or some combination thereof. In the case of usage, time (minutes of use) or quantity (volume of information transmitted) could be relevant depending on the nature of traffic carried.

As to rate averaging, the Commission has been a first hand witness to the competitive distortions such a policy has produced in the telecommunications industry. It would seem in the best interests of cable operators to determine cost of service at no higher than the franchise level to avoid the inevitable response of competitors to rates which reflect costs unrelated to a particular service.

<u>Affiliate Transactions</u>

The Commission proposes rules concerning transactions with affiliates to prevent cable systems from imposing the costs of nonregulated activities on regulated operations through improper cross-subsidization. Such rules would include programming costs. For purposes of establishing guidelines for determining whether an entity is an affiliate, the Commission defined an affiliate as one with a five percent or greater ownership in the cable operator.[26]

The affiliated transaction rules adopted by the Commission for telecommunications carriers[27] should likewise apply to cable operators. Arthur Andersen previously commented on such affiliated transaction rules[28] and continues to believe the rules should be modified in two respects:

1. A broader measure of fair market value of affiliated transactions to include, objective and verifiable prices charged by unaffiliated entities, should be used. The existing standard limits the use of market pricing to situations where the affiliate providing services must also offer the same services in substantial amounts to unaffiliated parties.

2. The asymmetrical asset transfer rules should be amended to utilize fair market value for transfers into and out of regulation.

As to the definition of an affiliate, the guidance under GAAP that significant influence is presumed with a 20% investment[29] should be used, rather than the 5% proposed by the Commission.

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[26] Notice at ¶ 67-69.
[27] 47 C.F.R. Section 32.27
[28] See comments filed by Arthur Andersen on June 30, 1986 in CC Docket 86-111.
[29] See APB Opinion No. 18, Paragraph 17.

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We appreciate the opportunity to comment on this Notice. Any questions regarding our comments or further communications should be addressed to Mr. Michael P. Husaby, 717-17th Street, Denver, Colorado, 80202.

Respectfully submitted,

Arthur Andersen & Co.

ARTHUR ANDERSEN & CO.

August 25, 1993